
In the United States
Circuit Court of Appeals
For the Ninth Circuit.

Commissioner of Internal Revenue,
Petitioner,

vs.

Marian Otis Chandler,
Respondent.

BRIEF FOR RESPONDENT.

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No. 8262

In the United States
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Commissioner of Internal Revenue,
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vs.

Marian Otis Chandler,
Respondent.

BRIEF FOR RESPONDENT.

Opinion Below.

The only previous opinion in this case is that of the United States Board of Tax Appeals [R. 52-60], which is reported in 32 B. T. A. 720.

Jurisdiction.

This appeal involves income taxes for the year 1929 in the amount of \$99,683.56, and is taken from an order of redetermination entered July 26, 1935 [R. 60]. The appeal is brought by petition for review filed October 19, 1935 [R. 61-73], pursuant to the provisions of the Revenue Act of 1926, c. 27, 44 Stat. 9, 109-110, Sections 1001-1003, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

Question Presented.

Did respondent derive taxable gain on account of the exchange by her of promissory notes and accrued interest for stock in the Chandis Securities Company, and if so, was that gain derived during the year 1929?

Statutes Involved.

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED. The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) General Rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(b) (3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(b) (5) TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or

securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * * * *

(i) DEFINITION OF REORGANIZATION.— * * *

(1) The term “reorganization” means * * *
(C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term “a party to a reorganization” includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) DEFINITION OF CONTROL.—As used in this section the term “control” means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Statement of Facts.

The facts found by the Board of Tax Appeals are as follows [R. 53-58]:

Harry Chandler, in 1916, incorporated the Chandis Securities Company with a capital stock of 500 shares (par value \$1,000.00 a share), for which stock he transferred to it certain real and personal property. He transferred 200 of such shares to his wife, respondent herein,

and 280 shares to his children. Later he transferred other properties to the company for its promissory notes, which he assigned to his wife and children, in approximately the same proportion as their stockholdings. On December 31, 1923, the interest which had accrued on the notes amounted to \$702,049.61. On that day, the Chandis Securities Company issued to the wife and children new notes for the foregoing notes and accrued interest. The accrued interest on the new notes amounted to \$875,008.67 on December 31, 1929.

On October 14, 1929, the board of directors of the company passed a resolution, increasing its capital stock from 500 shares of the par value of \$1,000.00 per share to 50,000 shares of the par value of \$100.00 per share. On December 18, 1929, the board of directors of the company passed a resolution authorizing the company's officers to apply to the Corporation Commissioner of the State of California for permission to sell or issue 40,000 shares of its capital stock at par to liquidate the indebtedness of the company to its stockholders. The resolution contained the following recitals and provisions [R. 55-56, 83-85]:

“Whereas, Chandis Securities Company is indebted to the following named persons, to wit:

Marian Otis Chandler

Franceska C. Kirkpatrick

May C. Goodan

Helen Chandler

Philip Chandler

Ruth C. Williamson

Harrison G. Chandler

Constance Chandler

Norman Chandler

in the aggregate principal sum of \$2,640,598.21 all of which is evidenced by several promissory notes of this company held by said persons, dated December 31st, 1923, due on or before the 31st day of December 1928, which notes bear interest at the rate of 5% per annum, compounded annually, on which no part of said principal or accrued interest has been paid, and

“Whereas, the aforesaid persons have expressed their willingness and have offered to accept stock in this corporation at full par value thereof in full or part payment of their respective notes together with interest thereon,

“Now, Therefore, be it resolved that, subject to the approval of the Commissioner of Corporations of the State of California, this corporation issue to any and/or all of the aforesaid persons in liquidation and payment of all or part of the indebtedness as aforesaid, together with interest thereon accrued to the time of the issuance, fully paid stock in this corporation at its par value for the amount of the indebtedness so liquidated and paid, and that this corporation take and receive from the persons aforesaid a cancellation and satisfaction of said notes to the extent that stock may be so issued to the respective holders thereof.

“And Be It Further Resolved, That the President and Secretary of this Corporation be and they are hereby, authorized and empowered to make application to the Commissioner of Corporations of the State of California, for a permit to sell and/or issue to and/or among the foregoing persons only, and none other, forty thousand shares of the capital stock of this corporation, at par, either,

(a) For cash, lawful money of the U. S., and/or

(b) Such amount thereof as may be necessary to pay, liquidate and discharge not to exceed the amount of the indebtedness to said persons, hereinbefore referred to, for principal and/or interest accrued on said notes to the time when said stock may be issued.”

On December 20, 1929, the company filed such application, which was granted on December 26, 1929. The permit contained the following provision [R. 57, 111-112]:

“1. To issue to any or all of the persons named in its application filed on the 20th day of December, 1929, an aggregate of not to exceed 35,156 shares of its capital stock as consideration for the cancellation of the indebtedness of applicant to them, described in said application; \$100.00 of such indebtedness to be cancelled upon the issuance of each of said shares.”

By its terms the permit expired December 26, 1931.

On January 2, 1930, the respondent and the children surrendered their notes in exchange for the stock certificates issued by the company that day, and the notes thereupon were canceled. The certificates were actually delivered in May, 1930. The canceled notes each bear on the face a receipt signed by the respective former holder as follows [R. 57]: “January 2, 1930. The receipt of capital stock of Chandis Securities Company in full settlement of principal and accrued interest to December 31, 1929 is hereby acknowledged.”

From 1924 to 1929, the company accrued interest on the above described notes at five per cent per annum and deducted such interest on its income tax returns. The company kept its books and made its income tax returns on the accrual basis, while the taxpayer and the children kept their books and filed their returns on the cash receipts and disbursements basis. The individuals did not report any interest received in connection with the above notes.

The notes in question were in the custody of Horace Downing, secretary of the company, throughout the year 1929. The balance sheet of the company on December 31, 1929, lists the notes of the taxpayer among its liabilities. The books of the company contain appropriate entries to show that the transactions were consummated in 1930. It was stipulated that the value of the stock of the company was \$60.00 per share at any time material to this proceeding.

The Commissioner urged that respondent derived a taxable gain on account of the exchange by respondent of her notes and accrued interest thereon for stock of the Chandis Securities Company based upon the fair market value of the stock so received by respondent. The Commissioner contended that this exchange was consummated during the year 1929, and the respondent contended it was consummated during the year 1930. Respondent contended that the exchange was a tax-free exchange within the meaning of Section 112 (b) (3) and (5) of the Revenue Act of 1928.

Summary of Argument.

Although the record [pages 67 to 73] discloses thirty-six separate assignments of error, no specifications of error relied upon are set out in petitioner's brief as required by Rule 24 (2)(b) of this Court. The contents of petitioner's brief would indicate that the assignments contained in the record, except those relating to the year of the receipt of the stock by taxpayers, are waived.

An agreement, if there be any, to subscribe for stock does not create taxable gain. The approval, on December 26, 1929, of the Corporation Commissioner of the State of California did not consummate an exchange by respondent of her notes for stock. The Chandis Securities Company could not legally issue the stock authorized by the permit until it had received payment therefor by cancellation of the debts. If we are not here dealing with a "sale of stock," then the question resolves itself into merely an academic question, because the Commissioner's proposed tax liability is based solely upon a sale of stock for notes and accrued interest. The cases cited by petitioner relating to the liability of subscribers to corporate stock and relating to the availability of funds have no application to the case at bar. The resolution of the board of directors of Chandis Securities Company definitely shows that the stock was not to be issued until the stockholders had surrendered their notes for cancellation. The finding of the Board of Tax Appeals that the notes were canceled and the transaction consummated in 1930 is conclusive upon this Court.

ARGUMENT.

There were two questions presented to the Board, namely: (1) did the exchange by the stockholders of Chandis Securities Company of notes and accrued interest thereon for new stock constitute a tax-free exchange within the meaning of Section 112 (b) (3) and (5) of the Revenue Act of 1928; and (2) was the exchange consummated during the year 1929?

The Board found as a fact that "On January 2, 1930 the petitioners surrendered their notes in exchange for the stock certificates issued by the company that day and the notes thereupon were cancelled." The Board then held that the exchange was not made in 1929 but in 1930 and therefore deemed it unnecessary to determine whether the exchange was tax-free since the deficiency proposed was for the year 1929.

The petitioner does not contend that there is no evidence to support the foregoing finding of the Board, hence, it would appear that under the established rule of law this Honorable Court would not disturb the Board's finding. The finding made by the Board is abundantly supported by undisputed evidence. The undisputed facts showing that the transactions were consummated after the close of the year 1929, are substantially as follows:

1. The interest for which the stock was received represented interest *to and including* December 31, 1929. [Stip. paragraphs 9 and 12, R. 77 to 80.]

2. The balance sheets of the Chandis Securities Company for December 31, 1929, reflected the notes and interest payable [Exhibit 3, R. 222]; the journal entries of the Chandis Securities Company disclosed that the transac-

tions were consummated in 1930. [Exhibit 4, R. 223 to 231.]

3. The notes of respondent and the other noteholders were canceled and surrendered on January 2, 1930 and each note had the following typewritten language written diagonally across its face under which the signature of each noteholder appears:

“January 2, 1930

THE RECEIPT OF CAPITAL STOCK OF CHANDIS SECURITIES COMPANY IN FULL SETTLEMENT OF PRINCIPAL AND ACCRUED INTEREST TO DECEMBER 31, 1929 IS HEREBY ACKNOWLEDGED.” [R. 164 to 204.]

4. The stock certificates which were given for the notes and interest bear dates subsequent to December 31, 1929, and the notations on the stubs show that the certificates were not received by respondent and the other noteholders until a date subsequent to January 2, 1930. [R. 230 to 250.]

5. Mr. Downing, Secretary of the Chandis Securities Company, testified that the notes held by respondent and the other noteholders were cancelled on January 2, 1930, and that in his presence respondent and the other noteholders signed his or her notes on January 2, 1930. [R. 119, 120, 121, 122, 128.]

The ingenious attempt of petitioner to have this Court, in the absence of proper specifications of error, treat the factual questions as legal issues is not supported by either facts, logic or law. Counsel for petitioner would have this Court ignore, without proper specifications of error, the positive and ultimate findings made by the Board. This Court has ruled under such circumstances that it will

not disturb the findings of the Board (*Winnett v. Helvering, Commissioner of Internal Revenue* (C. C. A. 9), 68 F. (2d) 614; *Tricou v. Helvering*, 68 F. (2d) 280), but irrespective of whether petitioner's brief complies with the rules of this Court, the decision of the Board of Tax Appeals should be sustained.

This Court on numerous occasions has held that it will not disturb the findings of the Board if supported by evidence and that in no event will this Court disturb these findings except upon proper assignments disclosing errors of law in the conduct of the lower tribunal. Inasmuch as the issue decided by the Board was a question of fact and inasmuch as the Board made findings thereon (which findings are abundantly supported by facts) the decision of the Board should be sustained. (*Holmby Corporation v. Commissioner of Internal Revenue*, 81 F. (2d) 1019; *Belridge Oil Co. v. Helvering*, 69 F. (2d) 432; *Burnet v. Leininger*, 285 U. S. 136, 138; *Phillips v. Commissioner*, 283 U. S. 589, 600; *Commissioner v. Bank of California* (C. C. A. 9), 80 F. (2d) 389, 390; *Commissioner v. Eldridge* (C. C. A. 9), 79 F. (2d) 629, 630; *Commissioner v. Gerard* (C. C. A. 9), 75 F. (2d) 542, 544.)

None of the cases cited by the petitioner have any bearing upon the issue in this case. It is elementary that a contract to subscribe for stock does not result in income to a taxpayer. A contract to subscribe is merely a contract to make an investment. A gain from capital is realized only upon a sale or exchange of capital. Petitioner's argument is based upon a misconception of law. Petitioner, in his brief, states, "we are here dealing with a subscription for stock and not a sale of stock." If we are not concerned with a sale or exchange, then it is quite

evident that in no event would the respondent be liable for the deficiency in controversy.

The obligation of the Chandis Securities Company to pay the principal of the notes to respondent was represented by the promissory note; likewise, the obligation of Chandis Securities Company to pay the interest was evidenced by the note. In short, both obligations arose out of the same transaction and are one and the same. They cannot be separated. Even though they could be separated, the taxpayer is not subject to tax on interest until received. Petitioner, in his brief, cites Regulations 74 as sustaining his contention that respondent constructively received, during the year 1929, the new stock of the Chandis Securities Company. A reading of this regulation clearly discloses that it was never intended to apply to the circumstances in the case at bar. The Regulations were intended to apply only when "income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time, * * * although not then actually reduced to possession." The Regulations also specifically state that, "To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition." There is certainly no evidence to support the laborious contention of petitioner that any income was credited or set apart to this taxpayer (respondent).

The Regulations also contemplate that stock issued by a corporation, to be taxable in the hands of stockholders,

must be received or at least made available to the stockholders. The Regulations specifically provide that, "Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt." Consequently, by no stretch of the imagination can the Regulations referred to by petitioner be made to apply to the circumstances in the case at bar.

We respectfully urge upon this Court that taxing statutes are concerned with realities and that a taxpayer becomes subject to tax only if he or she has received income. Section 42 of the Revenue Act of 1928 specifically requires that only amounts of income received shall be included in the return as part of the taxpayer's gross income. There is nothing in the record which in any way supports petitioner's theory that respondent received taxable income during the year 1929.

Petitioner, in his brief, relies mainly upon the resolution of the board of directors of Chandis Securities Company passed on December 18, 1929. Petitioner would have this Court believe that the transaction was completed for federal tax purposes at the time the Corporation Commissioner of the State of California issued his permit pursuant to the application of Chandis Securities Company.

Petitioner has overlooked that part of the resolution which definitely expresses the intent of the stockholders and the corporation with respect to the consummation of the deal. The resolution, among other things, states [R. 84]:

"Now, Therefore, be it resolved that, subject to the approval of the Commissioner of Corporations

of the State of California, this corporation issue to any and/or all of the aforesaid persons in liquidation and payment of all or part of the indebtedness as aforesaid, together with interest thereon accrued to the time of the issuance, fully paid stock in this corporation at its par value for the amount of the indebtedness so liquidated and paid, *and that this corporation take and receive from the persons aforesaid a cancellation and satisfaction of said notes to the extent that stock may be so issued to the respective holders thereof.*" (Italics supplied.)

The italicized portion of the resolution definitely indicates that the corporation was to receive from the note-holders the cancellation and satisfaction of their notes before any stock was to be issued. This fact alone very definitely supports the finding of the Board that the transaction was consummated subsequent to the year 1929 and on January 2, 1930. The new stock could not have been legally issued during the year 1929. To have issued the new stock prior to the date the notes were canceled would have been at variance with the application of the Chandis Securities Company and also would have been a violation of the permit granted by the Corporation Commissioner of the State of California. The directors and officers, if they had issued the stock prior to the time the notes were canceled, would have violated the provisions of the Corporate Securities Act and would have subjected themselves to criminal prosecution. See Act 3814, California General Laws 1931, Section 18, which reads as follows:

"Violation of act by officers, etc. Every officer, agent, or employee of any company and every other person, who knowingly authorizes, directs, or aids in

the issue or sale of, or issues or executes, or sells, or causes or assists in causing to be issued, executed, or sold, any security, in nonconformity with a permit of the commissioner then in effect authorizing such issue, or contrary to the provisions of this act, or of the constitution of this state, * * * is guilty of a public offense and shall be punished by imprisonment in the state prison not exceeding five years, or in a county jail not exceeding two years, or by a fine not exceeding five thousand dollars, or by both such fine and imprisonment.”

One of the oldest presumptions known in the law is that a citizen is presumed to comply with the laws; in other words, it is presumed, until the contrary is proven, that a corporation complies with the law. The petitioner in the case at bar, without any evidence to support him, would have this Court disregard this presumption, ignore the undisputed evidence, and hold that the corporation issued its stock contrary to the laws of the State of California.

Attention is also called to Section 298 of the Civil Code of California which provides as follows:

“Payment of consideration for shares. No shares of stock, with or without par value, shall be issued except in consideration of money paid, labor done, or services actually rendered, debts or securities canceled, or tangible or intangible property, actually received by the issuing corporation, or amounts transferred from surplus to stated capital upon the issuance of shares as a dividend.”

Under the provisions of the Code just quoted the cancellation of an indebtedness is a very important matter. It is not ministerial as the petitioner would endeavor to have this Court believe. The Legislature took great care

in providing that no stock should be issued until the indebtedness was canceled. It is, therefore, absurd for the petitioner to contend, under the circumstances, that the requirements of the Statutes of the State of California are merely ministerial in their nature. Certainly, the California Legislature intended them to be very positive requirements.

The California Statutes make every issue of stock void (not voidable) which is issued without a permit or in non-conformity with the provisions of the application. Attention is called to Section 16 of the Corporate Securities Act which reads as follows:

“Every security issued by any company, without a permit of the commissioner authorizing the same then in effect, shall be void, and every security issued by any company with the authorization of the commissioner but which has been sold or issued in nonconformity with the provisions, if any, contained in the permit authorizing the issuance or sale of such security shall be void.”

The Board's finding is supported by evidence which conclusively shows that the notes were not canceled until January 2, 1930. Until they were canceled no consideration had passed from the noteholders to the corporation. The application of the Chandis Securities Company to the Corporation Commissioner of the State of California states, among other things, that

“Said stock to be issued,

(a) Either for cash so as to net said corporation the full par value thereof, or

(b) Such portion thereof as shall be necessary to pay, liquidate and discharge not to exceed the aggre-

gate amount of the indebtedness of this corporation to said persons, which indebtedness is evidenced by promissory notes held by said persons as set forth in the schedule hereunto annexed marked Exhibit 'E' and made a part hereof and which indebtedness is for principal and interest on said promissory notes." [R. 88.]

The permit granted by the Corporation Commissioner was dated December 26, 1929, and it stated, among other things, that the

"Chandis Securities Company, a California corporation, is hereby authorized to sell and issue its securities as hereinafter set forth:

1. To issue to any or all of the persons named in its application filed on the 20th day of December, 1929, an aggregate of not to exceed 35,156 shares of its capital stock as *consideration for the cancellation of the indebtedness of applicant to them*, described in said application; \$100.00 of such indebtedness to be cancelled upon the issuance of each of said shares.

2. To sell and issue to any or all of the persons named in its application filed on the 20th day of December, 1929, an aggregate of not to exceed 4,844 shares of its capital stock, at par, for cash, lawful money of the United States, for the uses and purposes recited in its application, and so as to net applicant the full amount of the selling price thereof." [R. 111-112.] (Italics supplied.)

Attention is respectfully called to the language of paragraph 1 of the permit which stated that the stock was to be issued as "consideration for the cancellation of the indebtedness" described in said application and the indebtedness was "to be cancelled upon the issuance of each of said

shares.” The Chandis Securities Company was powerless to cancel the indebtedness; the power to cancel the indebtedness remained at all times in the noteholders. Until they canceled their notes and the indebtedness was “cancelled,” as authorized by the permit, the Chandis Securities Company could not issue the new stock without violating the Corporate Securities Act.

Petitioner, in support of his contentions, cited the case of *Pacific National Bank v. Eaton*, 141 U. S. 227. An analysis of this case shows that it does not support petitioner’s contention but in fact supports the contention of respondent. The Supreme Court in this case stated that “The fact that a person who takes and pays for stock in a bank did not call for and take his certificate of stock does not make any difference as to his status as a stockholder.” It cannot reasonably be contended that respondent and the other stockholders of Chandis Securities Company paid for their stock during the year 1929.

The petitioner also cites the case of *Western Pacific Paper Company, Inc., Respondent, v. Hollywood Topics, Inc., Defendants*, 113 Cal. App. 305. This case merely held that in an action to recover on stockholders’ liability, where defendant subscribed and paid for all but two shares of the stock of the corporation, and as secretary had it within her power to complete the contemplated transfer of part of the shares to the other officers by signing the certificates and making the appropriate entries in the books of the corporation, but failed to do so before departing for a foreign country, and plaintiff’s claim was based upon goods sold to the corporation while defendant was out of the country, she could not shift the responsibility to others by a denial of her ownership of the

stock originally subscribed for by her. These and other cases relied upon by the respondent are cases where equitable principles have been applied to protect creditors against the claims of people who had held themselves out to be stockholders or who had actually subscribed for stock. These cases, it is respectfully submitted, have absolutely no bearing upon the issues involved in this case.

The statute by its expressed provisions imposes liabilities on gains received during the taxable year. A taxpayer does not receive taxable income merely because he enters into a contract for the sale of goods or property. A gain is realized only when the transaction is closed and the contracting party, the taxpayer, receives either property or cash in excess of the cost of the property he transferred. The petitioner states in his brief, "The stockholders had obligated themselves to deliver the notes for cancellation; the date of the actual cancellation is immaterial." This statement is not a fair statement of the resolution upon which the petitioner relies.

Petitioner, in his brief, states: "It was wholly within their power to complete the transaction contemplated under the corporation resolution by issuing the stock, canceling the notes, and by making appropriate entries to show ownership of the stock in themselves. Having failed to do that which they could have done, they may not shift the incidence of ownership to a later year. * * * Nor should the taxpayer be permitted, through failure or refusal to accept income, to select the year in which to report it."

The quoted statements present a very strange and un-American philosophy. Taxpayers, under the statutes, are not compelled to sell their property; they are not com-

pelled to take income in a year that the Commissioner of Internal Revenue would like to have it taxed. The record does not sustain the petitioner in his assertion that the taxpayers refused to accept income. This is a very unfair and unwarranted statement on the part of petitioner. The record shows very definitely that the proceedings of the Chandis Securities Company and the stockholders were conducted with dispatch. The resolution of the board of directors was passed on December 18, 1929, the application for permit to the Corporation Commissioner was subscribed and sworn to before a notary public on the 18th day of December, 1929; and the Corporation Commissioner issued his permit on December 26, 1929. There remained only four days to consummate the transaction during the year 1929. This Court will take judicial notice of the fact that these four days constitute part of a week which is generally devoted to holiday festivities, but even though they could be considered as full business days it is not fair to assume that the taxpayer and other note-holders of Chandis Securities Company and the corporation were deliberately attempting to avoid the incidence of income tax by not consummating the deal during that year. In short, when the evidence is fairly considered, there is no reasonable justification for the inference that respondent and the other taxpayers refused to accept income during the year 1929. They, as stockholders owning all but 20 shares of Chandis Securities Company, knew that they were getting only shares of stock in place of notes. They knew that they were not realizing any gain but that they were merely converting capital represented by notes for capital in the nature of stock certificates.

However, even though the taxpayers had deliberately delayed (which they had not) canceling and exchanging

their notes for their stock, they could not legally be held to have received taxable gain during the year 1929. Certainly there could have been no advantage to respondent and the other stockholders of Chandis Securities Company in having the transaction consummated in 1930 instead of 1929. Capital gain for both years was taxed at the same rate, to wit, $12\frac{1}{2}$ per cent (see Section 101 Revenue Act of 1928). It is recognized that a stock certificate constitutes evidence of ownership of stock in a corporation and under certain circumstances possession is not essential to the ownership thereof. Nevertheless, the date of issuance of a stock certificate does constitute evidence as to when the interest in the corporation was acquired. However, we are concerned in the instant case with a provision of the statute which levies taxes on income "*received*." The findings of the Board, supported by abundant evidence, are conclusive that the notes and accrued interest thereon were exchanged and the stock certificates received in the year 1930. The notes show they were canceled on January 2, 1930 [R. 162-203], and that the stock was subsequently received. This is also supported by the uncontradicted evidence of Horace E. Downing.

Counsel for petitioner infers that respondent derived taxable income on account of the exchange of her notes and interest for stock. This exchange was a tax-free exchange.

Prior to the transactions herein referred to respondent and the other noteholders owned all, except 20 shares, of the capital stock of Chandis Securities Company. They also held notes of Chandis Securities Company on which interest had accrued and had not been paid. The Chandis Securities Company recapitalized by increasing its num-

ber of shares of stock, reducing the par value per share and increasing the aggregate par value of its stock. A portion of the new stock was issued to the stockholders for their old stock and a portion of the new stock was issued for the principal and interest on the notes. Interest had accrued on the notes up to December 31, 1923 in the total sum of \$702,049.61 at which time new notes were given for principal and interest. The interest that accrued on the notes from January 1, 1924 to and including December 31, 1929 amounted to the total sum of \$875,008.67. The same individuals who owned the stock prior to the reorganization were the stockholders after the reorganization. The stock given for the notes and interest was issued to respondent and the other taxpayers in the same proportions as they had theretofore owned the notes and immediately after the reorganization they owned more than 80% of all the stock of the Chandis Securities Company.

It has been the policy of Congress, as expressed in several successive revenue acts, to except from the operation of the general provisions of the Acts certain gains or losses, and the taxing of such gains or the allowance of such losses has merely been deferred. Section 112 of the Revenue Act of 1928 contains the provisions for the recognition or non-recognition of gains or losses. Subdivision 5 of this section specifically provides as follows:

“TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securi-

ties in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.”

Since respondent and the other stockholders transferred the principal and interest represented by their notes to the Chandis Securities Company “solely in exchange for stock * * *, and immediately after the exchange,” owned at least 80% of its stock, they derived no taxable gain. The transaction comes definitely within the provisions of the quoted section. Indeed, it is most respectfully submitted that there is no justifiable reason for dispute. The statute is very clear and it is inconceivable that it would have any application if it did not apply to the undisputed facts herein presented. Respondent and the other stockholders transferred their notes and interest solely for stock and therefore “no gain or loss shall be recognized.” The stock was issued to respondent and the other stockholders in the same proportion as they had theretofore owned the notes and interest accrued thereon and immediately after the exchange they owned at least 80% of the stock of the Chandis Securities Company. The exchange, therefore, comes squarely within the spirit as well as within the letter of the law.

The deficiency proposed by the petitioner was based upon the assumption that notes and accrued interest were not

property within the meaning of the statute. The Supreme Court of the United States has held that there is nothing in the Revenue Acts to suggest that the word “property” was used in any restricted sense. (*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 45 Sup. Ct. 274.) This Honorable Court in the case of *Halliburton v. Commissioner*, 78 F. (2d) 265, held that “money” was property within the meaning of the Act. Therefore, it is quite evident that the notes held by respondent and her children constituted property within the meaning of the foregoing section.

It is quite difficult to conceive of a reason for making a distinction between the interest and the principal of the notes. It is generally recognized that the interest accrued on a note is as much a part of the obligation, as much a part of the note, as the principal itself. Section 1084 of the Civil Code of California states:

“The transfer of a thing transfers also all its incidents, unless expressly excepted; * * *.”

The obligation of the Chandis Securities Company to pay interest is as much a part of the notes as is its obligation to pay the principal of the notes.

A note is merely evidence of an obligation to pay a certain sum of money and interest; likewise, a bond is a similar obligation. The word “property” is used in subdivisions (b) (1), (b) (4), (b) (5) of Section 112. It is also used in subdivisions (c), (d), (e) and (f) of Section 112. It is also used very many times in Section 113. It is

respectfully urged that Congress used the word “property” in the sense it is commonly understood, which, of course, would include all kinds. Notes have been considered property since time immemorial.

In any event respondent and the other stockholders of Chandis Securities Company did not receive taxable income merely because they exchanged their notes for new stock in the Chandis Securities Company. They were no richer after the exchange than before. They merely held a different class of property, and in fact Chandis Securities Company merely recapitalized by increasing its issued stock for which it received from its own stockholders the cancellation of its indebtedness. Section 112 (i) of the Revenue Act of 1928 defines a reorganization as meaning, among other things, “(C) a recapitalization, or (D) a mere change in identity, form, or place, or organization, however effected.” These provisions of the statute must be given some effect and when applied to the circumstances in the case at bar it is plainly evident that these taxpayers did not derive taxable gain on account of the exchange by them of their notes and interest for stock in the Chandis Securities Company.

The Commissioner in the cases of *Daniel H. Burnham, Petitioner, v. Commissioner of Internal Revenue, Respondent*, and *Hubert Burnham, Petitioner, v. Commissioner of Internal Revenue, Respondent*, 33 B. T. A., (unreported to date), promulgated October 3, 1935, took the position that respondent is now taking. The facts in these cases are almost identical with the facts in the case at bar.

The petitioners in these cases owned practically all of the stock of the Courts Building Corporation. They and their wives owned unsecured promissory notes of the corporation. Refinancing became necessary and in 1929 the corporation was recapitalized. The holders of the promissory notes exchanged notes and their rights to accrued interest for new stock of the corporation in pursuance of the plan of reorganization. The Board of Tax Appeals held that petitioners in these cases did not derive taxable income. The Board held that the transaction came within the provisions of Section 112 (b) (3) of the Revenue Act of 1928 which provides as follows:

“No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.”

It seems strange that the Commissioner of Internal Revenue in the *Burnham* cases would contend that the transaction was a tax-free exchange and before this Court take the position that respondent derived taxable income. Of course, in the cases heretofore quoted the Commissioner was endeavoring to disallow a loss whereas in the case at bar he is endeavoring to establish a gain for the purpose of proposing a tax!

In view of the foregoing and particularly in view of the fact that the Board of Tax Appeals, after hearing the testimony of witnesses and weighing the evidence, found

as a fact that the respondent and the other stockholders of Chandis Securities Company on January 2, 1930 surrendered and canceled their notes in exchange for the stock certificates, the decision of the Board of Tax Appeals should be sustained.

Respectfully submitted,

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